

Testimony

Of

Thomas J. Fraser

CEO, First Mutual Holding Company, Lakewood, OH

*before the*

*Committee on Banking, Housing and Urban Affairs*

*United States Senate*

July 20, 2023

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Thank you, Chairman Brown, Ranking Member Scott, and Members of the Committee, for the opportunity to testify today for your hearing “Perspectives on Depository Insurance Reform after Recent Bank Failures.” This is a critically important hearing and an important step in the process, and I deeply appreciate the opportunity to provide you and your colleagues with my views on deposit insurance reform from the perspective of the banking industry.

I am Thomas J. Fraser, CEO of First Mutual Holding Co, in Lakewood, Ohio. First Mutual is a \$2.9 billion no-stock private mutual holding company and community steward of five mutual banks ranging in size from \$30 million dollars to \$2 billion. Our five banks serve Ohio, West Virginia, Kentucky, and Virginia. Our banks and holding company are owned by our depositors. We have no public shareholders First Mutual knows how critical access to safe banking is to consumers and small businesses in Appalachia, the industrial Great Lakes, and underbanked urban neighborhoods in Cleveland and Cincinnati.

Other mutual banks serve similar constituencies throughout our country. Mutuals represent about 425 or 8% of the banking charters in the United States, split evenly between Federal Savings Associations and state-chartered banks. All are less than \$10 billion in assets; most are less than \$250 million in assets. Mutual banks are concentrated in New England, the mid-Atlantic, Great Lakes, and the industrial Midwest. With no shareholders, mutual banks are taxpaying cooperative entities – owned by our members (owner-customers) – providing the same banking services as other stock banks. We are subject to the same regulatory rigor and oversight as any other bank. We contribute into the Deposit Insurance Fund. For perspective, most of the mutual industry customer deposits are fully insured; only 24% of mutual bank deposits are uninsured. Over 83% of First Mutual’s deposits are insured.

### **Deposit Insurance Protects Consumers**

Our five mutual banks in First Mutual Holding Co. believe that deposit insurance is an important part of the banking social contract with our owner-customers and with our community. Our owner-customers gain additional confidence from FDIC backing. In exchange for this, it is appropriate that our banks lend those insured deposits into our communities in a manner

sensitive to and consistent with the Community Reinvestment Act and on a fair and equitable basis. Mutual bankers know federal deposit insurance is an important safeguard, one that no bank on its own would have access to or be able to afford without the FDIC. Deposit Insurance exists to preserve stability in our banking system and to benefit our customers. Management teams – myself included -- sometimes are tempted to view deposit insurance premiums as an expense or tax. In reality, insurance is a powerful consumer protection tool that reinforces our stable deposit bases, not an entitlement to bankers.

Our mutual banking model is built around two important foundations: responsiveness to our owner-customers and stewardship in perpetuating the mutual community asset we are entrusted to manage. Thus, mutual bank leaders make decisions for the long-term, seeking to balance risk-taking with setting our customers and small businesses up for success. The model is straightforward. An owner-customer makes a deposit; it is safely reinvested back into the community in the form of a loan; it generates a reasonable and fair return which in turn is retained as capital in the institution. As a result, mutual banks tend to be very well capitalized.

Depositor confidence is critical to the banking model in general, and is essential to the mutual model, as our depositor is also effectively an owner of the mutual bank. This alignment of depositor and ownership interest best showed itself during the great financial crisis 15 years ago. Mutual bank failures were almost non-existent. And for the few troubled mutual institutions that did exist, they were easily merged into other like-minded mutual institutions with no cost to the Deposit Insurance Fund.

The events of this past March raised new questions about the stability of the industry's deposit base for several days. Since then, however, both mutual and non-mutual community bank deposit bases have held up well. Deposit insurance performed as expected. Customers understood the business models and risk profiles of the local and regional banks and separated that from the failed banks' exotic business models and excessive risk-taking. Our customers ultimately were only concerned about the risk of contagion.

Regulators acted quickly to diffuse any contagion. I am aware this Committee has had other hearings related to root causes and regulatory oversight. I agree that interest rate and liquidity risks accumulated by the novel failed banks were the result of various concentrations and risk management practices sitting on top of their idiosyncratic business models. Instantaneous funds transfers enabled by technology and fueled by social media's fire drove the failures. Ultimately, these banks had vulnerable deposit franchises susceptible to new trends in technology gutting their unproven business models.

### **Contribution of Emergent Risks to Recent Bank Failures**

No insurance scheme can fully account for all risks, and no legislative or regulatory solution can be expected to solve all the problems or prevent all bank failures. Since March, however, it has become evident to me that emergent risks may have contributed to the failures of those banks.

The risks enumerated below did not exist in the 2008 crisis but should be considered in modeling any deposit insurance reform:

- 1) Mobile Technology and Artificial Intelligence may make all deposit bases more vulnerable as customers can transfer funds in a few minutes – bank runs can turn into bank sprints.
- 2) Banks are competing with non-bank money market funds who offer high rates without FDIC guarantees through access to reverse repo facilities at the Federal Reserve. This facility pays high interest rates (currently 5.05%) on reserves to non-banks. This also limits lending as those funds are removed from the banking system. It is not part of the social contract in banking.
- 3) Fed Funds rates increased from near zero to over five percent in a little over a year. The yield curve has remained inverted for a prolonged period. Conventional bank models use 3 to 4 percent rate increase shocks as a standard with a variety of curve shapes. Curve inversions are presumed to be transitory, not persistent.
- 4) More shadow banks and FinTechs offer bank-like deposit services. Sometimes blurring what should be a bright line of deposit insurance expectations and coverage. Non-banks continue to become involved in the financial system and in payments in a much less regulated manner and without deposit insurance, which means that many banks are not competing on a level playing field. Recent estimates suggest 43% of new checking and payment accounts this year have been opened such non-bank entities.
- 5) Large private credit firms are now raising money from retail investors to lend to businesses. They are now competing with banks for deposits as well as loans, all while operating outside the regulatory perimeter, not subject to the stringent bank regulations. Private debt is now a \$1.5 trillion business globally, compared to about \$300 billion in 2010.
- 6) Underlying risk model assumptions about deposit betas (how fast deposits reprice given an increase in rates) and deposit longevity may be changing. At the least, these assumptions require constant updates to models, which well-run institutions routinely perform. Behind these assumptions are changes in where customers place excess funds. In addition to non-bank expansion into deposits and payments, banks are also competing with T-bills; some T-bills have been paying rates as high as 5.50%, and retail customers can easily invest in them via the Treasury Direct platform. No bank can ever compete with the Federal government; but these funds are no longer available to banks to lend to our communities. Technology enables quick transfers to non-bank money market funds and to Treasury Direct.
- 7) The deposit base in the United States remains 30% larger than the pre-pandemic base. So, the insurance base is larger and thus the size of uninsured deposits is also larger. Existing limits may not be adequate in a crisis.
- 8) By law, the FDIC has prescriptive and limited actions it can take in resolving failed institutions, which may be unintentionally distorting deposit flows in a crisis and limiting the pool of banks who can acquire a failing bank.

- 9) The population of able banks who can acquire failed banks is smaller than 2008. There are quantitatively fewer bank charters and qualitatively limited banks with adequate book capital to absorb a troubled institution without a loss-sharing agreement.

In spite of the new risks above, the current FDIC deposit insurance has performed remarkably well. Both the FDIC and the Federal Reserve quickly restored confidence and liquidity and ended the crisis at its root source. Liquidity sources have been made available that appear not to pose any risk to the financial system. Other hearings have documented supervisory concerns about those specific failed banks. At a mutual community bank level, however, I note that our regulators have been very active in monitoring the conditions of our five banks. This observation is shared by other community bankers with whom I interact. Regulators have been actively engaged – even before March -- in challenging assumptions and raising risk management expectations in light of changing risks and possible economic scenarios.

### **Options for Deposit Insurance Reform**

FDIC and others have promulgated ideas and options for deposit insurance reform. Most acknowledge the current system has done its job in promoting stability. And all accept reform is a complex issue with no clear cut, obvious path. Policymakers, consumer advocates, thinktanks, and bankers make compelling cases for changes along three broad paths: limited/no expansion of current scheme; targeted-type changes based on account type and/or amount; or blanket insurance on all accounts.

As I mentioned earlier in my comments, any insurance reform should remain centered on impacts to consumer protection (individuals and businesses) and confidence in the stability of our banking system. Bankers and policymakers must maintain those two objectives highest, among others. All current proposals are thoughtful about identifying impacts on moral hazard, risk taking, who bears the cost, who rides free, who wins and who is possibly harmed. And finally, while important to bankers, earnings impacts are a tertiary consideration when weighed against those objectives, especially given deposit insurance's value during a crisis. Invested capital is a powerful force and will always find a return.

Given the changing risk landscape, reform options should also account for changes in risk factors from the last crisis which I outlined earlier in my remarks. Reform must rigorously assess unintended consequences of making policy changes. Though taking no action can be damaging as well – new risks can fester unchecked with outdated policy tools. Implied guarantees can grow as shadow market participants conclude that insurance may inevitably someday apply to their activities.

Finally, should a bank wind up in FDIC receivership, resolution should also consider long-term competitive concentrations beyond just expedited, low-cost resolutions. FDIC has proven to be an effective insurance provider and manager of banks in receivership. Congress should consider

providing FDIC additional stand-in tools beyond the Systemic Risk Exemption to resolve failed banks in a manner that does not cause deposit and asset concentrations in large institutions after a crisis.

### **Conclusion**

No regulatory scheme, nor deposit insurance reform can totally account for excessive risk taking, poor management, and bad behavior. Policymakers should accept that it is hard enough for banks to keep up with technology and changes in the financial system. It is even a bigger challenge for regulators and Congress to match that pace. I respectfully ask that any reform should keep the tenets expressed here in mind, particularly with respect to consumers and systemic risk. Do not let the pursuit of perfection be the enemy of good. Even with the best tools, there are going to be mistakes in oversight. But our job as policymakers and bankers is to minimize unintended impacts, protect consumers and businesses, and perpetuate confidence in the banking system. I suspect this will be one of several hearings and discussions surrounding the deposit insurance fund and appreciate the committee's focus and attention to this important pillar of support for our industry.

Thank you once again for the opportunity to testify before the Committee and I look forward to answering your questions.